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# Features

## Phoenix turned to ashes

### *The Spanish Socialists' response to the economic crisis*

**Paul Kennedy**

**The Spanish Socialists entered 2011 in a state of crisis.** Re-elected in March 2008, shortly before the scale of the international economic downturn became apparent, José Luis Rodríguez Zapatero's government initially appeared to underestimate the scale of the difficulties faced by the Spanish economy, with Zapatero claiming in April 2009 that Spain was already over the worst. By May 2010, however, under pressure exerted by the financial markets and the country's EU partners, Zapatero announced an austerity programme aimed at slashing Spain's deficit to 6 per cent of GDP by the end of 2011, a cut of more than €50 billion over two years.

Despite the implementation of the programme, which included a 5 per cent reduction in the salaries of government workers and a freeze on public pensions, an EU bailout along the lines of that requested by Greece and Ireland cannot be ruled out during the course of 2011. With unemployment not likely to dip much below 20 per cent for the foreseeable future, and further unpopular measures in the pipeline such as the postponement of the retirement age from 65 to 67, the Spanish Socialists find themselves in an extremely difficult situation in the run-up to the general election which is due by March 2012.

This article seeks to chart the decline in the Socialist government's fortunes since it repeated its 2004 general election victory in 2008. Although an overall majority had eluded the Socialists at both elections, their achievements in office have been considerable, with the introduction of legislation aimed at combating domestic violence, the legalisation of gay marriage, and a significant extension of the welfare state in the form of a Dependency Law which provided financial aid to those requiring or providing care. Moreover, Zapatero had backed a wide-ranging reform of the statutes that govern the responsibilities enjoyed by Spain's seventeen autonomous regions, which had been broadly popular. The Socialists' social democratic credentials were also evident in a 40 per cent increase in social spending.

But the travails of the Spanish economy are the dominant theme of this article, given that they are likely to be the key factor in deciding the next general election, crowding out other policy issues. Whereas the very buoyancy of the Spanish economy during the Socialist Party's first term in office had the effect of dampening down debate on economic policy, the Socialists' subsequent term has been dominated by the economic crisis. As we will see, the economic downturn has served to diminish Zapatero's credibility and that of his government. Initially denying the gravity of the situation, as well as the serious structural weaknesses of the Spanish economy, the government was forced to reassess its approach, losing further credibility by having to implement tough austerity measures which,

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previously, it had emphatically ruled out. The impression was one of improvisation, ineffectiveness, and, ultimately, impotence.

### The Spanish growth model

Economic policy prior to the downturn had broadly been in line with that pursued by the Socialists' centre-right Popular Party predecessors in government, led by José María Aznar. With Spanish economic growth outpacing the EU average since the mid-1990s, there appeared to be little incentive for the Socialists to reject a model largely based on the construction and housing sectors.

The Socialist Party's criticism of the economy's dependence on excessive levels of debt and the construction sector had nevertheless featured prominently in its manifesto in the run-up to its victory at the 2004 general election, with reference being made to the 'cult of bricks and mortar'; the 'escalation of private sector indebtedness, of both families and companies'; and 'the current risks concerning the Spanish economy, which is highly indebted and geared towards bricks and mortar' (PSOE, 2004, 103-4).

The prominent role played by the construction sector in Spain's buoyant economy prior to the 2008 downturn can be appreciated by the following figures: construction accounted for 10 per cent of GDP by 2007, well above the 5 per cent average figure of Spain's EU partners (O'Kean, 2010, 19). Employment in the construction sector rose from 1.2 million in 1996 (9 per cent of the labour force) to 2.7 million (13 per cent of the labour force) in the second quarter of 2007. This meant that there were almost as many people employed in construction as there were in the whole of the industrial sector in 2007 (Salmon, 2010, 46). Spain accounted for 40 per cent of the jobs created in the eurozone in the 15 years up to 2007, many of which were linked to construction (Chislett, 2008).

Prior to the downturn, Spain boasted some of the best economic indicators in the EU. Economic growth averaged 3.5 per cent during the decade 1996-2006, outpacing that of the eurozone (2.1 per cent) and the United States (3.3 per cent). Fiscal surpluses were achieved throughout the Socialists' entire first term in office (2004-2008), at a time when considerable public deficits were the norm throughout the EU, and public sector debt decreased by 9 per cent between 2004 and 2007, leaving a figure below 40 per cent. Spain's unemployment rate fell to 8 per cent in 2007, below the EU average, and the lowest since democracy was established following Franco's death in 1975.

Such healthy figures indicate why the Socialist government was reluctant to carry out a radical reform of the economic policy foundations on which such impressive figures were built. Nevertheless, the government laid itself open to justified criticism with respect to its tardiness in acknowledging the shortcomings of the construction-based economic model and the need to replace it with an alternative economic approach.

By the time of the March 2008 general election it was already clear that the construction and housing sectors were experiencing difficulties, posing questions about the viability of the Spanish economic growth model. In addition to this dependence on the construction and property sectors, the economy displayed a number of key weaknesses, including a large current account deficit (around 10 per cent of GDP in 2007), low levels of productivity, weak indicators related to the knowledge economy, a high degree of dependence on imported energy, and a dual labour market in which one-third of the labour force was employed on short-term contracts with little or no protection, whereas the other two-thirds were protected by measures which made it expensive for companies to adjust to changing market conditions (Salmon, 2010, 40).

It was the crisis within the construction sector, however, which was the most notable

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element in Spain's economic downturn from early 2008: house prices fell by 15 per cent between 2007 and 2010, and whereas there were 860,000 new builds in 2006, there were just 110,000 in 2009, a fall of 87 per cent. The consequent job losses in the sector were considerable: around two million jobs were lost in the three-year period up to 2010, over 60 per cent of which were either directly or indirectly linked to the construction sector (Presidencia del Gobierno, 2010, 12, 28).

### Responding to the crisis

As the intensity of the economic downturn became increasingly apparent in the period after the 2008 general election, the government's key election pledges, such as its aim to create 2 million new jobs and bring the unemployment rate down to 7 per cent (PSOE, 2008, 22), appeared unrealistic. Unemployment rose steadily, reaching 14 per cent and affecting 3.2 million people by the end of the year, by which time Spain was technically in recession, only emerging during the third quarter of 2010 after seven consecutive quarters of negative growth. The government responded by making use of the relatively healthy public finances in the run-up to the crisis, injecting €11 billion into the economy in an effort to create 300,000 new jobs, with the majority of the money going to local authorities via a dedicated public investment fund.

With the public deficit continuing to rise steadily throughout 2009, as tax revenues declined and spending on unemployment benefits increased, disagreements emerged over the direction of economic policy. The Governor of the Bank of Spain, Ángel Fernández Ordóñez, appointed by the Socialists in 2006, called for a thorough reform of the Spanish labour market and, in particular, the country's system of collective bargaining, but was snubbed by Zapatero, who refused to countenance a reduction in the costs associated with laying people off (Chislett, 2009). Similar disagreements led to the replacement of Pedro Solbes, Finance Minister since Zapatero entered office, with Elena Salgado in April 2009. Solbes had been reported as being at odds with Zapatero for having had misgivings about the relaxation of budgetary restraint linked to the funding of the fiscal stimulus measures favoured by the Prime Minister. In relative terms, Spain's fiscal stimulus package was one of the largest implemented by governments seeking to address the economic downturn, reaching €42 billion between 2008 and 2009, equivalent to 4 per cent of GDP, approximately 2 per cent for each year (Presidencia del Gobierno, 2010, 12, 41).

By the autumn of 2009, the scope for discretionary spending had in any case diminished considerably, as market and political pressure was building on the government to identify a strategy to contain public expenditure and reduce the public sector deficit, which had reached 11 per cent of GDP by the end of the year, largely as a result of the fiscal stimulus measures. As early as February 2009, the European Commission, in accordance with the excessive deficit procedure of the Stability and Growth Pact, had issued a warning to Spain over the size of its deficit, necessitating a shift from fiscal stimulus to cuts in pay, employment and investment across the public sector, so as to meet the target deficit figure of 3 per cent of GDP by 2013 (Salmon, 2010, 43).

The austerity now required lay behind the relative timidity of the government's Sustainable Economy Bill, its attempt to establish a new economic model to replace the discredited construction-based approach, unveiled in November 2009. The initiative consisted of a package of measures aimed at securing a more competitive model of production which would be economically and environmentally sustainable. Dominated by measures on the transparency of pay packages for the directors of publicly quoted companies, sustainable tourism, the streamlining of the convoluted process of setting up a

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business, and ensuring that public administrations made more prompt payment to suppliers in an effort to prevent further business failures, the package was generally viewed as falling far short of its stated objectives. Most notably, it failed to provide the structural reforms required in such areas as the labour market, education, the country's energy model and pensions, all of which would have to be addressed in order to produce a genuine change of economic model (Abellán, 2009, 20).

The shock engendered by the release of worse-than-expected economic indicators in January 2010, and the revelations concerning the Greek economic situation, prompted the government into taking further action on the economy. With the economy contracting by 3.7 per cent during the course of 2009, the deficit remaining above 11 per cent of GDP, and the number of unemployed totalling 4.3 million – just under 19 per cent of the labour force – the government announced an ambitious austerity plan which aimed to reduce the deficit to 9.8 per cent of GDP in 2010 and 7 per cent in 2011 – a cut of more than €50 billion in a year, €10 billion of which would be contributed by local and regional governments. Most prominent among the proposals was the decision to increase the retirement age from 65 to 67 in order to guarantee the sustainability of the public pensions system.

Despite these initiatives, the government was forced into implementing further austerity measures just four months later as a result of pressure from the markets, which had concerns about the growth prospects of the Spanish economy and the effect of this on the government's capacity to meet its deficit reduction targets, and from the European Commission, which by now was beset by the crisis within the eurozone. It was also reported that President Obama telephoned Zapatero to urge him to act robustly. The government agreed to reduce the deficit by more than had been agreed in January 2010, pledging to reduce the public deficit to 9.3 per cent of GDP in 2010 and 6 per cent in 2011 – 1.5 per cent more than had been proposed just four months before – so as to bring the deficit down to 3 per cent by 2013.

This necessitated a further package of cuts, which included an average 5 per cent reduction in civil servants' salaries in 2010, followed by a pay freeze in 2011; the ending on 1 January 2011 of an allowance of €2,500 to those giving birth, which had been introduced in July 2007; a pensions freeze in 2011, albeit exempting those in receipt of the minimum pension; an extra saving of €1.2 billion by local and regional governments; a 6 billion reduction in public sector investment; and a €600 million cut in development aid between 2009 and 2010. The aim was to save a further €15 billion over the period 2010-2011. The measures obtained the approval of parliament by a single vote.

The response of public sector workers was to hold a strike in June 2010 to protest against the austerity package. The threat of a strike did not prevent the government from proposing further measures in the same month, including a reduction in the amount of redundancy pay received by those on permanent contracts. This initiative was viewed by some as being a missed opportunity to carry out a more thorough reform of the labour market, including a modification of the system of collective bargaining. Relations between the government and trade unions had by now deteriorated to such an extent that a general strike was held in September 2010, although the relative lack of popular support for the strike did little to boost the credibility of the trade unions.

By the autumn of 2010, the government's situation was looking sufficiently perilous for there to have been some doubts as to whether the government would be able to gain parliamentary approval for its tough 2011 budget, which proposed a cut in public spending of almost 8 per cent, although a deal was eventually struck with the Basque Nationalist Party (PNV) and the Canary Coalition (CC). This support was necessary because the failure to approve the budget may have forced the government to bring forward the general election.

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Any satisfaction enjoyed by the government quickly dissipated when the Catalan branch of the Socialist Party, which had been in office in the Catalan regional government since 2003 as part of a centre-left coalition, obtained its worst ever result at the regional elections in November 2010, gaining just 18 per cent of the vote, a fall of 9 per cent compared to the last regional elections in 2006. The result was particularly worrying for Zapatero since support in Catalonia had been a vital element in his general election victories in 2004 and 2008.

An opinion poll carried out by Metroscopia for the Socialist-leaning *El País* newspaper in January 2011 indicated the challenges facing the Socialist Party (*El País*, 2011, 12-13). When asked about the current economic situation in Spain, 87 per cent viewed it as being either bad or very bad, although Zapatero could gain some consolation from the fact that whilst 80 per cent of respondents indicated that he inspired little or no confidence in them, an even higher percentage – 83 per cent – had little or no confidence in the opposition leader, Mariano Rajoy. Asked whether Zapatero should stand for a third term as Prime Minister, 78 per cent said that he should not; even 76 per cent of those describing themselves as Socialist supporters thought that another candidate would be preferable. With respect to voting intentions, the Socialist Party was at 28.6 per cent, 14.5 per cent behind the Popular Party, which enjoyed the support of 43.1 per cent, indicating the likelihood of a clear Popular Party victory at the next general election.

## Conclusion

The very buoyancy of the Spanish economy between the mid-1990s and the international economic downturn of 2008 is the chief factor which explains the Socialists' reluctance to change the fundamentals of economic policy. Possessing a public debt which was well below the EU average and a healthy surplus in the public accounts throughout its entire first term in office, it is perhaps understandable that the Socialist government was slow to appreciate both the rapidity and the gravity of the downturn from 2008 and put in place an alternative model for a return to economic growth. In an interview which he gave to *El País* in November 2010, Zapatero indicated that before the economic downturn he had been criticised for running successive budget surpluses, 'because a Socialist Government should invest and increase public spending ... in the markets, the perception of our public accounts was excellent'.

Market instability in May 2010 nevertheless left Zapatero with no choice other than to toughen the economic austerity programme so as to underline the government's resolve to tackle the public deficit. Had he not done so, 'the following day market instability and doubts about sovereign debt, including our own, would have placed us in a difficult situation ... the markets were capable of placing our future solvency in question' (*El País*, 2010, 17-18). A combination of pressure from both the markets and the EU – concerned that Spain might cause a systemic crisis within the eurozone far more serious than that caused by Greece and Ireland – constrained the Socialists' margin for manoeuvre in the economic sphere.

The period until the general election is due in March 2012 does not promise to offer the Socialists much succour. Political debate will be concerned with pension reform and extensive changes to the Spanish labour market, which will not be welcomed by the Socialists' core supporters or the trade unions, with whom Zapatero had been able to establish an excellent relationship before boom turned to bust. Nor are economic growth forecasts promising. Whereas the government has indicated that growth in 2011 will total 1.3 per cent of GDP, the EU and the IMF have been less sanguine, predicting half that figure (Presidencia del Gobierno, 2010, 33).

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Whilst Zapatero has not yet confirmed whether he will stand for a third term in office, it has been suggested that he might be replaced by the time of the general election by his Interior Minister, Alfredo Pérez Rubalcaba, who was promoted to the position of First Deputy Prime Minister in October 2010.

It is not clear whether such a move would significantly transform the Socialists' prospects. The sovereign debt crisis continues to cast its shadow over the entire political arena and the need for financial support from the EU cannot be ruled out. Of particular concern are issues such as the dire financial position in which many of Spain's savings banks find themselves, given their exposure to the crisis within the construction sector, and the lack of financial transparency of the regional and local levels of government, whose income has also been reduced considerably by the collapse in the property market.

Furthermore, Spain's decentralised constitution means that, by 2011, the regional and local levels of government are responsible for half of public spending, and will therefore have a key role to play in Spain's deficit reduction programme. Prompted by the government in 2010, Spain's autonomous regions agreed to make public their budgetary positions on a quarterly basis, but tensions between the different levels of government as extensive spending cuts are required are likely to be considerable, threatening to destabilise both the political and economic situation further. Whether the austerity programme put in place by the Socialists can bring about the cuts required to meet the public deficit targets remains a moot point.

Although calls for Zapatero to step down are likely to increase in the event of poor results at the local and regional elections, which take place in May 2011, such a move would leave any successor in an unenviable position with less than a year to go before the general election. The Zapatero era appears to be drawing to a close, with little progress having been made in putting in place the new economic model which Spain so desperately needs.

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